Standard Deduction and Personal/Dependency Amounts for Children Age 14 and Over or Students

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Summary

Generally, a taxpayer is allowed one exemption for each person claimed as a dependent. The taxpayer can claim the dependent if the individual meets five tests for dependency. As a result of the *Working Families Tax Relief Act of 2004*, the tests for certain dependents, children, were simplified when a uniform definition of a qualifying child was adopted. A taxpayer may claim dependency exemptions for children 19 through 23 years of age who are full-time students at least five months during the year.

Between 1954 and 1986, it was possible for both a parent and his or her child or full-time student to claim the child's or student's personal/dependency exemption. Under a provision of the *Tax Reform Act of 1986 (TRA86)*, if the parent claimed the exemption, the child or dependent student could not claim their own personal exemption. However, the *TRA86* also provided a standard deduction for children/students equal to the greater of $500 *or* earned income up to the full standard deduction applicable to other types of taxpayers. These amounts have been adjusted annually for inflation. A provision included in the *Taxpayer Relief Act of 1997*(*TRA97*) preserved a full offset for earned income against the standard deduction amount but also provided a more generous offset where there is both earned and unearned income.

Special tax rules commonly referred to as the "kiddie tax" apply to the unearned investment income of children under the age of 14. These rules were recently modified by the Tax Increase Prevention and Reconciliation Act (P.L. 109-222), which increased the age of minors subject to this tax to those minors under age 18.

This report will be updated to reflect legislative changes and/or indexation adjustments.

Interrelationship Between the Personal/Dependency Exemption and Standard Deduction

Under existing law, adult taxpayers who do not itemize deductions can reduce their adjusted gross incomes by a personal exemption and a standard deduction, both of which are adjusted annually for inflation. In 2006, the amount of the personal exemption is $3,300. The amount of the standard deduction varies according to filing status. In tax year 2006, the standard deduction amounts that taxpayers may deduct from their income are $5,150 if single; $7,550, as the head of a household; or $10,300 if married and filing jointly. The standard deduction is thought of as a proxy for itemized deductions.

Tax policy recognizes that children/dependent students are not completely separate from their parents, and there have often been limitations on the kinds and amounts of income that children/students could receive tax free, including limitations imposed by restricting exemptions and deductions.

Tax law prior to the 2006 enactment of the Tax Increase Prevention and Reconciliation Act (P.L. 109-222) required minors under age 14 are taxed on their unearned income (i.e., passive income such as interest) at their parent's marginal tax rate. The new law increases the age of minors subject to this tax to those minors under age 18.

Under law prior to 1954 (the *Internal Revenue Code of 1954*), the standard deduction or former zero-bracket amount could offset earned income of a child/student, but not unearned income such as interest and dividends. Unearned income, however, could be offset by the personal exemption. The *Tax Reform Act of 1986 (TRA86;* P.L. 99-514*)* eliminated the personal exemption for children/students who were claimed as dependents on a parent's return and permitted a child/student an offset of up to $500 in the form of a partial standard deduction. This partial deduction could be used against unearned income. This original $500 amount has been subject to an inflation adjustment. In 1998, the modification made by the *Taxpayer Relief Act of 1997* (P.L. 105-34) took effect, with the maximum standard deduction for children and dependent students being the greater of $750 (regardless of composition) or earned income plus $250 not to exceed the standard deduction amount.[1]

The personal exemption amount stood at $1,080 prior to the 1986 change with the law providing that unearned income of a child/student could be offset against that amount. But, the 1986 act no longer allowed a personal exemption to the child/student when claimed on a parent's tax return. At the same time, however, the *TRA86* permitted a partial standard deduction to children/students. So, for 2006, the child/student with no earned income is able to shelter up to $800 of unearned income. This $800 amount will continue to be adjusted in future tax years.

In the case of children/students with $1,080 or more in unearned income and who also have earned income, the amount of wages that can be offset has risen from $2,480 before the 1986 Act (the zero bracket amount for single individuals) to $5,150 in 2006 (an increase of $2,670). However, for those children/students who only had earned income, the amount has only risen from $3,560 (the former zero bracket amount plus the personal exemption amount) to $5,150 (an increase of $1,590). These dollar amounts are in nominal terms and are not a reflection of inflation-adjusted amounts.

[1] At the time of enactment, the $750 was the projected inflation adjusted amount for tax year 1998. This amount is adjusted for inflation and may be greater or lesser in future tax years.

In those cases where the child's/student's income exceeds $800 in any combination of earned and/or unearned income *or* $5,150 in earned income (whichever is greater), filing a separate tax return will be necessary for the child/student. Often, it is necessary to file a separate return even when the child's/ student's income falls below these levels to receive a refund of taxes previously withheld.[2]

Five-Test Eligibility for Dependency Exemption

A key element in determining the tax status of a child or student is to establish whether they meet the criteria for dependency. To claim a dependency exemption *for any person* under present law, five tests must be met.

- **Gross income test**—a taxpayer cannot claim a person as a dependent if the person had gross income that exceeds the personal exemption amount. Tax-exempt income is not included in the gross income test. Gross income is measured before allowing for expenses of earning income or other items deductible for income tax purposes. For example, an individual with investment income of $3,101 incurring $600 in selling expenses could not be claimed as a dependent, although his or her adjusted gross income is only $2,501, well below the personal exemption amount. The *only* exceptions to this rule are for a taxpayer's child who is under the age of 19 or who qualifies as a student under the age of 24, and for disabled dependents with income attributable to earnings from a sheltered workshop. In this instance, the availability of medical care at such workshop must be the principal reason for his/her presence there, and the income must arise solely from activities at such workshop which is incidental to such medical care.
- **Support test**—the taxpayer must furnish more than one-half of the support of a person for the taxable year unless a multiple support agreement covers the person. There are special support rules for children/students of divorced or separated parents. Excludable income, not counted in the gross income test, is counted in determining whether the taxpayer has furnished over half the dependent's support. For example, public social welfare benefits, while excluded from gross income, are treated as support by the state.
- **Member of household or relationship**—a person need not be related to the taxpayer to qualify as a dependent if he or she is a member of the taxpayer's household and lives with the taxpayer for the entire year. Alternatively, certain dependent relatives need not live with the taxpayer or be a member of the taxpayer's household to be claimed as an exemption. For example, parents, grandparents, and student children of the taxpayer may be claimed as dependents even if they live in a separate domicile.
- **Citizenship test**—with a lone exception for certain adopted children, a dependent must be a citizen or national of the United States, or a resident of the United States, or a resident of Canada, Mexico, the Panama Canal Zone, or the Republic of Panama. A few residents of the Philippines are also covered.

[2] The information provided in this report applies to children between the ages of 14 and 18 as well as full-time students between the ages of 19 and 24. For additional information see CRS Report 87-21A, *Minor Children's Income: Effect of the Tax Reform Act of 1986*, by Marie B. Morris.

- **Joint return test**—a taxpayer is not allowed an exemption for a dependent if the dependent is married and files a joint tax return.

As a result of the Working Families Tax Relief Act of 2004 (P.L. 108-311), the rules for the dependency exemption for children were modified when a uniform definition of a qualifying child was adopted. The uniform definition states that a child is a qualifying child of a taxpayer if the child satisfies three tests. The first test requires that the child have the same principal place of abode as the taxpayer for more than one half of the taxable year. The second test requires that the child have a specified relationship to the taxpayer. The third test restricts the age of the child to under 19 for purposes of the dependency exemption. The new law eliminates the need for taxpayers to meet the gross income and the support tests for dependency when claiming a child for the dependency exemption, as long as the child meets the uniform definition.

Students

Taxpayers may claim dependency exemptions for children 19 through 23 years of age who are full-time students at least five months during the year, even if the children have gross income in excess of the personal exemption amount ($3,300 in 2006) and could not normally be claimed. Other standard dependency tests must be met, including the taxpayer's provision of one-half of the dependents' support. These dependents cannot claim personal exemptions on their own returns, however, and their standard deduction may be lower. In 2006, with some exceptions, the standard deduction for students is equal to the greater of $800 (in any combination of earned or unearned income) or their earned income plus up to $250 of unearned income providing it does not exceed the standard deduction amount of $5,150 for single taxpayers. If the student's income is greater than these amounts, he or she must file a tax return.

The Internal Revenue Code defines a full-time student as a student who attends an educational organization during some part of each of five calendar months of the taxpayer's calendar year. This five-month period is not required to be consecutive. Individuals may be classified as students if they attend either an educational organization or if they pursue a full-time course of institutional on-farm training under the supervision of an accredited agent or an educational organization. The Code defines an educational organization as one that maintains a "regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."[3]

Brief History

Prior to1954, if a child or student earned more than $600 (the amount of the personal exemption at the time), then the parent lost the ability to claim a dependency exemption for the child/student. The *Internal Revenue Code of 1954* made the personal exemption available to both the parent and child/student. Otherwise, children/students who worked part-time to help defray the cost of their education could cause the loss of the dependency exemption to their parents, even though the parents still provided more than half the child's/student's support. Thus, between 1954 and the passage of the *Tax Reform Act of 1986* (*TRA86*), it was possible for both the parent and child/student to offset income by claiming a personal/dependency exemption for the same individual.

Under provisions introduced by the *TRA86*, if the parent claimed the dependency exemption, the child/student could not also claim it. However, the *TRA86* also provided a standard deduction

[3] Internal Revenue Code §170(b)(1)(A)(ii).

amount for children/students equal to the greater of $500 (combination of earned and/or unearned income) *or* earned income up to the generally applicable standard deduction amount. That law also provided that these amounts be indexed for inflation in future tax years.

While not expressly stated in the explanation of the *Tax Reform Act of 1986*[4] prepared by the staff of the Joint Committee on Taxation, it may be inferred that the rationale for the 1986 change in the personal/dependency exemption was threefold. One was consistency: no other exceptions are available for a person to be claimed as an exemption on more than one tax return; the general rule can be simply stated as one personal exemption per person. The second reason was that the combination of the personal exemption and the standard deduction was designed to provide a safety net to those near the poverty threshold. The intention was that those individuals near the poverty line would not be obliged to pay federal income taxes. Income of dependents does not relate to the poverty threshold in the same way; for example, a child with little income of his or her own may live in a high-income household. The third reason was that the Congress was concerned that some high-income taxpayers were shifting assets to their children in an attempt to lower income subject to the parents' higher tax rates. To the extent they shifted that income into lower tax brackets, federal revenue collections were lowered.

While a personal exemption cannot be claimed by a child or student on his or her tax return when a dependency exemption is claimed by a parent, there are some compensating factors. The exemption amount was almost doubled by the passage of the 1986 Act. As such, we could say that Congress shifted some of the value of the personal exemption from the children/students to the parents. Since the income of the parent was generally larger than the income of the child/student, (placing the parent in a higher tax rate bracket) it followed that the value of a dollar of personal exemption or standard deduction could be higher for the parent than for his or her child/student filing a separate return.

The *Taxpayer Relief Act of 1997* modified the standard deduction of dependents as a simplification measure. The provision was included in the House passed version and remained unchanged when reported by the Senate's Committee on Finance. The Finance Committee's report stated that the reason for change was the belief by the committee " ... that significant simplification of the existing income tax system can be achieved by providing larger exemptions such that taxpayers with incomes less than the exemption are not required to compute and pay any tax. The committee particularly believes that the present-law exemptions of dependent children are too small."[5]

The act increased the standard deduction to the greater of $700 (the prior $500 amount adjusted for inflation) or the sum of $250 and earned income, but not to exceed the full standard deduction. Thus, under provisions of the act, children/students with earned incomes greater than $700, but less than the standard deduction amount who have small amount of unearned income (up to $250) would no longer have the unearned income taxed nor have to file a tax return. This change became effective for tax year 1998.

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[4] U.S. Congress, Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1986*, report to accompany H.R. 3838, 99th Cong., 2nd sess., JCS-10-87, (Washington:GPO, 1987).

[5] U.S. Congress, Senate Committee on Finance, *Revenue Reconciliation Act of 1997*, report to accompany S. 949, 105th Cong., 1st sess., S.Rept. 105-33 (Washington:GPO, 1997), p. 222. Washington, G.P.O., 1997. p. 222.

Author Information

Pamela J. Jackson
Section Research Manager

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